

CITY ATTORNEY ANALYSIS

CITY OF SAN DIEGO STRUCTURAL BUDGET DEFICIT

February 28, 2008

The San Diego City Attorney commends the Independent Budget Analyst (IBA) for issuing her Report “City of San Diego Structural Budget Deficit” (IBA Report Number 08-14).¹

In the report the IBA concludes the City of San Diego is facing a “structural deficit.”²

A major cause of the City’s current “structural deficit” is that pension benefits were granted without funding in 1996, 2000 and 2002.

These benefits consisted of three rounds of retroactive benefits without funding which cost taxpayers \$451 million. In addition, pension officials gave away 8,000 years of pension credits to city employees for free, at a cost to taxpayers of \$146 million.

Another major unfunded benefit was the Deferred Retirement Option Plan (“DROP”). It was supposed to be operated on a cost neutral basis. However, the City’s outside actuary put the cost to taxpayers at more than \$200 million.³ There are over 500 retirees holding pensions with a present value in excess of \$1 million. The average public safety pension has a present value of \$900,000.

Facing a billion dollar and growing pension deficit, City officials have traded away road repair, water security, and fire prevention to pay employees more to retire than to work.

The IBA described the problem as a structural deficit. The Securities and Exchange Commission (SEC) described the problem similarly: the “City would have difficulty funding its future annual pension contributions unless it obtained new revenues, reduced pension benefits, or reduced City services.”⁴

Year after year, the City has opted to cut services. It has not raised revenues nor has it cut employee benefits. Pension officials, with the blessing of high level City officials, have continued to issue rosy predictions. The IBA Report has brought a much needed dose of reality to the situation.

In the report the IBA notes that since 2003 the City has had to annually implement budget reductions (cut departmental budgets) which translate into reductions in city services.

¹ See attached summary of key findings of the IBA Report.

² A structural deficit occurs when the growth of total government expense consistently outpaces the growth of total revenues over a period of consecutive years. A structural deficit forms part of the public sector deficit. A structural deficit differs from cyclical deficit in that it exists even when the economy is at its potential.

³ For a detailed explanation of the unfunded benefits see San Diego City Attorney Interim Report 24.

⁴ SEC Cease and Desist Order p. 16.

Increases in the City's contributions to the pension plan, over the period analyzed by the IBA (2003 to 2007), were \$257 million. The budget reductions for the period were \$121 million. In other words, substantial budget reductions have been required to fund pension obligations.

The following chart shows how increases in the City's contributions to the pension system exceeded the budget reductions.

Year	How Much Budget Went Down	How Much Pension Contribution Went Up	Annual City Pension Contribution
2003	\$10.3m	\$7.4 m	\$68,562,430 ⁵
2004	\$28 m	\$42.5 m	\$111,141,840
2005	\$23.3 m	\$48.7 m	\$159,893,945
2006	\$23 m	\$130.6 m	\$290,560,025 ⁶
2007	\$35.9	\$27.5 m	\$187,396,563
Total	\$121m	\$257 m	\$817,554,803

The City is caught in a structural deficit trap. Total contributions from the City and City employees to the pension increased from \$81 million in 2000 to \$236 million in 2007. Total contributions during this period were \$1.42 billion.

But over the same period \$1.7 billion or \$300 million more than contributions, poured out of the pension in benefits and costs. These costs and benefits increased from \$127 million in 2000 to \$315 million in 2007. On-going pension expenditures consistently exceed on-going pension contributions.

Year	Employee Contributions	City Contributions	Total Contributions	Deductions
2000	\$29,533,246	\$51,894,996	\$81,482,242	\$127,240,420
2001	\$36,360,970	\$55,323,168	\$91,684,138	\$173,542,969
2002	\$54,640,917	\$61,151,177	\$115,792,094	\$169,815,247
2003	\$62,712,108	\$68,562,430	\$131,274,538	\$176,904,391
2004	\$92,886,011	\$111,141,840	\$204,027,851	\$202,666,835
2005	\$71,661,307	\$159,893,945	\$231,555,252	\$248,633,256
2006	\$41,662,341	\$290,560,025	\$332,222,366	\$305,261,712
2007	\$49,074,662	\$187,396,563	\$236,471,225	\$315,000,000
TOTAL	\$438,531,562	\$985,924,144	\$1,424,509,706	\$1,719,064,830

Pension benefit costs also grew faster than plan assets during the period. From 2000 to 2007 benefit costs increased from \$3.68 to \$6.84 billion, an increase of \$3.16 billion, while assets

⁵ The City's pension contribution in 2002 was \$61,151,177.

⁶ The City made a one time contribution of \$108 million in 2006. The increase shown here relies on 2005 as the base year and the computation is based upon how much the contribution in 2007 exceeded the contribution in 2005.

went up only \$1.6 billion.⁷ Even when investment earnings are added to pension contributions, the benefits continue to grow faster than assets.

This can be seen in the following table:

Yr	Market Value of Assets	Benefit Costs
2000	\$2,999,010,145	\$3,681,800,000
2001	\$2,807,446,618	\$3,890,000,000
2002	\$2,609,623,272	\$4,382,900,000
2003	\$2,780,080,379	\$4,941,000,000
2004	\$3,368,239,286	\$5,467,447,943
2005	\$3,210,721,975	\$5,957,900,719
2006	\$3,981,931,694	\$6,475,469,077
2007	\$4,641,340,923	\$6,844,230,197
2000-2007 Increase	\$ 1.6 Billion	\$ 3.16 Billion

LEGAL BACKGROUND

The court suit pending before the appellate court is based, in part, upon the State Constitution and City Charter provisions that do not allow Cities to create structural deficits. Those two laws prohibit Cities from creating deficits based upon unfunded benefits. If the appellate Court rules that the benefits must be set aside, the structural deficit will be significantly and materially reduced.

The laws provided in pertinent part as follows:

California State Constitution Art. 16 § 18. (a) No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election.

Section 99: Continuing Contracts

The City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless the qualified electors of the City [approved it at an election].

The City Attorney cited the history of structural deficits also know as “floating debt” in the City Attorney’s 6th Interim Report.

In the 6th Interim Report, the City Attorney cites extensive authority that debt increases in violation of the pay-as-you-go spending restrictions in the City Charter or State Constitution should not be imposed on taxpayers.

The 6th report also cites case authority stating that any contract created in violation of the spending limit is void:

⁷ See San Diego City Attorney Interim Report 24, pp. 8, 21, 23-24.

[T]he contract is void because the statute prescribes the only method in which a valid contract can be made, and the adoption of the prescribed mode is a jurisdictional prerequisite to the exercise of the power to contract at all and can be exercised in no other manner so as to incur any liability on the part of municipality. *Reams v. Cooley*, 171 Cal. 150, 154 (1915) ⁸

The framers of the California State Constitution placed the liability limits into the State Constitution to avoid floating indebtedness (unfunded debt passed to future generations):

The system previously prevailing in some of the municipalities of the State by which liabilities and indebtedness were incurred by them far in excess of their income and revenue for the year in which the same were contracted, thus creating a floating indebtedness which had to be paid out of the income and revenue of future years, and which, in turn, necessitated the carrying forward of other indebtedness, was a fruitful source of municipal extravagance. The evil consequences of that system had been felt by the people at home and witnessed elsewhere. It was to put a stop to all of that, that the constitutional provision in question was adopted. *San Francisco Gas Co. v. Brickwedel*, 62 Cal. 641, 642 (1882).

The term “structural deficit” has wide use throughout the country amongst those struggling to fund the level of services demanded by taxpayers. In San Diego the people must understand the role of illegal and unfunded pension obligations in the City’s structural deficit. In other words, already hard-pressed city services and operations will be slashed for untold years into the future, unless illegal pension benefits are rescinded.

The IBA should be commended for making a strong case that San Diego cannot continue ignoring the pension crisis and the harmful and irreparable damage it is doing to our City.

⁸ San Diego City Attorney Interim Report 6, pp 45-48.